

The Constitutional Convention convened in Independence Hall in Philadelphia on May 14, 1787. The stated goal was to revise the Articles of Confederation. As the meetings progressed, however, the delegates decided to draft an entirely new framework for a new government. The result was the U.S. Constitution, which was eventually ratified by all 13 states and took effect in 1789.

Without the efforts of one key person, it never would have happened. He had retired from public life to run his farm and spend time with his wife and two adopted children. Because his business had declined during the Revolutionary War, there was much for him to do. He typically rose at dawn and caught up with his letters. After breakfast, he mounted his horse and rode out into his estate to inspect work being done, to give directions, and to plan improvements. In the evening, he relaxed with family and friends, read, played cards, or maybe enjoyed a dance. From his quiet retreat, however, he was slowly drawn back into public affairs. He knew things were going badly. He wrote, "We have errors to correct. We have probably had too good an opinion of human nature in forming our confederation."<sup>1</sup>

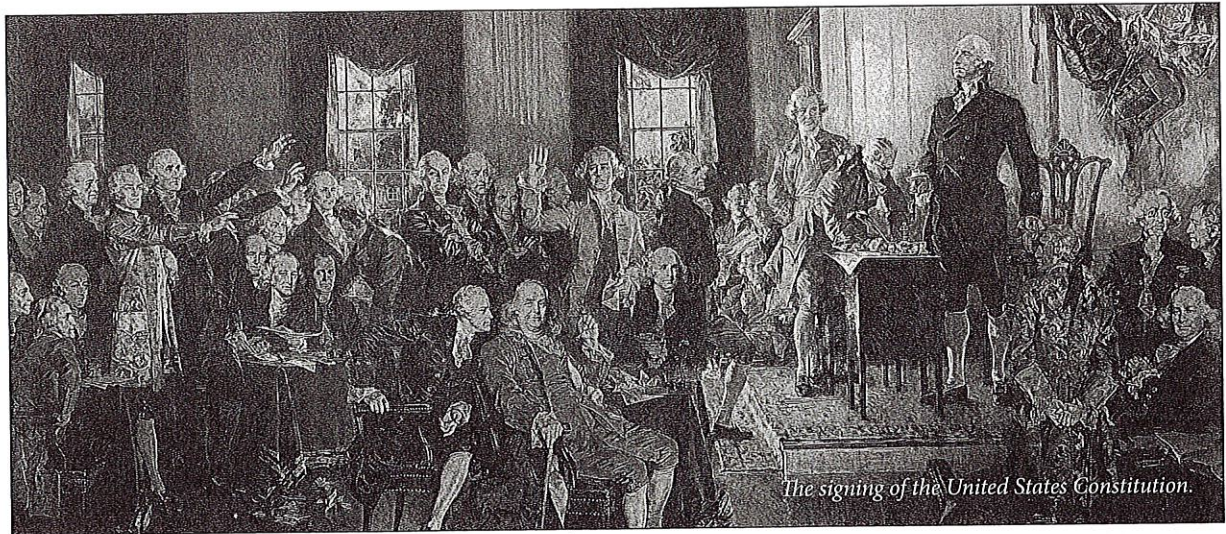
### KEY ECONOMIC CONCEPTS

Market economy  
Rules of the game  
Free trade zone

Gross Domestic  
Product (GDP)  
Command economy

He was approached by state leaders who asked him to head up Virginia's delegation to the Constitutional Convention. At first he declined, but they persisted, arguing that his presence was critical to dignify the Convention and to show that there was no secret plan among the delegates to establish a monarchy. He finally agreed to serve as a delegate, and on May 25, 1787, he was chosen by a unanimous vote to serve as president of the Convention. His name was George Washington.<sup>2</sup>

Rarely do people get a chance to "reset" their government. But that is exactly what Washington and the other Founders did. They wrote new rules for how the central government of the new nation would operate. The Constitution they wrote established a framework for the central government, describing the powers of the President, Congress, the Supreme Court, and the



*The signing of the United States Constitution.*



states. It also has proved to be the basis for the world's most successful and enduring democracy. But the Constitution is an economic document. It has contributed to the development of the world's most prosperous economy. We know how the U.S. Constitution provided for political freedom through the Bill of Rights. In what ways did the Constitution establish economic freedom as well?

### **The Historical Context Economic Conditions under the Articles of Confederation**

The Articles of Confederation had been adopted in 1781. They represented the first attempt by the Americans to establish a new government after the Revolution. Memories of British rule and the struggle to be rid of it were very fresh. As a result, many of the Founders then were reluctant to grant power to a central government. But the new nation later faced three severe economic problems that had to be addressed.

1. The Congress of the Confederation had incurred an enormous debt. Large amounts of money were owed to France and to people who held bonds sold during the war. Large commitments had been made to war veterans. And the government needed to pay its employees. But the Congress of the Confederation had no power to tax; only the states could do that. The Congress of the Confederation had to rely on revenue provided by the states. Not surprisingly, state legislatures were reluctant to make the payments requested by the Congress of the Confederation. They had their own financial problems.
2. Trade wars between the states loomed. States were free to impose tariffs—taxes—on imports from and exports to other states. Although in the short term these tariffs might help the states raise tax revenue to pay for their own operating expenses, in the long term tariffs would lower the standard of living in the new nation by making goods and services more expensive for consumers. Yet

the Congress of the Confederation had no power to stop the states from imposing tariffs on one another. It had no power to regulate trade between the states.

3. The military forces of the new nation were in tatters after having fought a long war. But the nation still faced threats on all sides, and this was no time to rest. The British occupied territories in the Great Lakes region, in clear violation of the Treaty of Paris. Spain denied Americans navigation rights on the Mississippi River. Barbary pirates were raiding American shipping in the Mediterranean Sea. But without the power to tax, the Congress of the Confederation had no way to establish and maintain an army or a navy.

The conveners of the Constitutional Convention were deeply worried about these problems. The Federalists among them, supporters of a strong central government, believed the new nation was in crisis and urgently needed a new constitution to hold it together. The Anti-Federalists opposed establishment of a stronger federal government and later argued against ratification of the new Constitution.

### **Adam Smith and the Economics of the U.S. Constitution**

Ideas from two important documents published in 1776 helped to shape the new Constitution. One was the Declaration of Independence. The Declaration announced that the 13 colonies would no longer be part of Britain. It stated that "all men" are created equal and that they possess unalienable rights—rights that a legitimate government cannot take away. It explained that people establish governments to protect those rights. If a government fails to meet its responsibility, it is the right of the people to abolish that government and replace it. These principles have had a profound impact on modern history in the United States and elsewhere.

The other influential document published in 1776 was a book written by Adam Smith. It is known today by its shortened title, *The*

*Wealth of Nations*. This book also changed the course of history. It established the intellectual foundations of modern economics, and it dealt with the economic issues that the delegates to the Constitutional Convention in Philadelphia needed to address.

*The Wealth of Nations* explained basic concepts of a **market economy**, including the need to protect private property rights, the importance of the profit motive, and the benefits of free trade. The American Founders were familiar with *The Wealth of Nations*; some of them knew it well. Thomas Jefferson frequently quoted from Smith in his papers and letters. The ideals of economic freedom expressed by Smith appealed to the Founders, as they did to many other Americans—people accustomed to making their own economic choices with little intrusion from the government.

## Economic Features of the New Constitution

Delegates to the Constitutional Convention sought to address economic weaknesses in the Articles of Confederation. How could widespread gains in productivity, and the prosperity these gains would bring about, be achieved in the new nation? And, as a practical matter, how could the powers of the new federal government be expanded and yet limited? To address the latter problem, the Founders adopted the Bill of Rights, which placed explicit limits on the exercise of governmental power. They also created an innovative constitutional structure—a system of checks and balances. The goal of the checks-and-balances system was to limit the central government's power by establishing separate governmental branches: a bi-cameral (that is, a two-chamber) legislative branch (the U.S. Congress), an executive branch (the presidency), and a judicial branch (the federal courts, including the U.S. Supreme Court). They designed this structure to make it impossible for the central government to get very much done unless it acted on the basis of broad agreement.

The Founders were highly suspicious of the powers of a central government. They knew

all about the capacity of interest groups to use governmental power for their own benefit. James Madison in *Federalist Paper No. 15* called interest groups “factions.” He and others wanted to make it difficult for any faction to use government for its own purposes—for example, by redistributing income from one group and giving it to another group.

Today, thousands of bills are considered by Congress each year, yet only a handful eventually are enacted into law. That outcome often comes in for criticism, but it is consistent with what the Founders intended. Critics complain when their favored bills are not enacted into law; other observers contend that checks and balances impede efforts to redistribute income from the rich to the poor or from the poor to the rich. The outcome is one that Adam Smith would have approved. He believed people should establish productive enterprises, earn an income by producing goods and services other people are willing to pay for, and rely on themselves and their families in times of need.

Certain specific features of the Constitution have played an especially important role in establishing a market economy in the United States. These features established the **rules of the game**; these rules, in turn, have acted as powerful incentives, influencing people's choices.

One example has to do with taxation. Under the Articles of Confederation, the central government could not collect taxes. But Article I, Section 8, of the U.S. Constitution—the Taxation clause—states that Congress shall have the power “to lay and collect taxes.” This provision enabled the new nation to solve some serious problems. It provided the U.S. government with a reliable way to raise revenue, pay off its debts, and defend its interests. Paying off debts calmed fears that the new nation would be unable to obtain loans from banks in other nations in the future. It built trust, and the trust it built provided an incentive for bankers in Europe to lend money to the new nation, which had previously seemed like a risky proposition. Taxation would also provide the revenue needed to finance an army and a navy to defend the nation's interests against Britain, Spain, France, and the Barbary pirates.





*Franklin, Hamilton, and others discuss the framing of the U.S. Constitution.*

Even so, the Anti-Federalists worried about granting the power of direct taxation to the federal government. They feared that abuse of this power could result in the reestablishment of something resembling a monarchy. At the time, however, the Founders were searching for a balance between federal authority and economic freedom. A market economy depends on government to perform certain critical functions, among which is national defense. Without the power to tax, the new nation could not raise an army or a navy to defend its political and commercial interests. In a weak nation, businesses would suffer. The chance of earning profits in an insecure environment is greatly reduced.

The Constitution also enabled the new nation to deal with problems related to interstate commerce. In creating the European Union, late in the 20th century, several European countries gained an opportunity to conduct business in a free trade zone. A **free trade zone** is an area in which trade barriers such as tariffs (taxes on imports) and quotas (numerical restrictions on imports) are reduced or eliminated. The U.S. Constitution established a free trade zone in the United States 200 years earlier. It did so by

means of Article I, Section 8, Clause 3, of the U.S. Constitution—the Commerce Clause—which states that Congress shall have power “To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.” The Commerce Clause took the power to impose tariffs away from the states, thus preventing states from engaging in trade wars (“If you place a tariff on corn we Iowans export to Minnesota, we’ll place a tariff on timber you Minnesotans export to Iowa”). Trade wars conducted with tariffs as weapons would reduce trade between the states and discourage specialization.

There was nothing imaginary about the problem of interstate trade wars. Memories were fresh of the time when New York had imposed a fee on vessels traveling to and from Connecticut and New Jersey. New Jersey then retaliated by imposing a tax on a New York lighthouse on New Jersey soil. If such trade wars became widespread, they would stifle economic growth and reduce prosperity in the new nation. In providing for the regulation of interstate commerce only at the federal level, the Commerce Clause did away with the threat of interstate trade wars.

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## **HISTORICAL QUESTIONS & ECONOMIC ANSWERS**

### **Is it true that individuals could “walk away” from debts before the establishment of the Constitution?**

Yes. Under the Articles of Confederation, each state could make its own decisions about how contracts would be handled. Farmers facing foreclosures, for example, sometimes pressured local and state governments to let them walk away from debts they owed according to contracts they had signed. Another debt-related issue had to do with loans from foreign sources. Some Americans argued that state legislators should not pay back foreign loans issued during the Revolution. The bonds in question were held after the Revolutionary War by “speculators” or foreigners, it was said, as if people answering to those descriptions should have no legal standing. But the Founders were concerned that if contracts were not enforced by the government, no one in the future would have confidence in the new U.S. financial system.

They drafted, accordingly, Article I, Section 10, Clause 1, of the new Constitution, called the Contract Clause. It states that “No state shall...pass any...law impairing the Obligation of Contracts,” thus ensuring that contracts, including those dealing with debts, would be enforced. The Contract Clause helped to make day-to-day business transactions stable and predictable. It provided an incentive for business owners to expand their operations without fear that the government might intrude to help out one party to a contract (say, the debtor) to the detriment of the other party (say, the lender).

### **The Fifth Amendment to the U.S. Constitution focuses on protecting the rights of suspected criminals, right?**

Not exactly. The Due Process Clause of the Fifth Amendment does indeed protect certain rights people have if they are questioned by police or arrested. But the Amendment does

much more than that. In its Takings Clause, for example, it states that the government may not take private property for public uses without paying “just compensation.”

The Takings Clause of the Fifth Amendment established the principle that the government itself is not above the law. Given the protection for private property it established, individuals could invest in their farms and businesses without fear that the federal government might some day, for some reason, confiscate their property. Today, in nations such as Zimbabwe and Venezuela, where economic freedom is not well protected, citizens do worry about the possibility that the government might confiscate their businesses or their savings, with little or no compensation. It is a threat that can generate crippling fear and stifle economic activity. Would you invest in a business or keep money in a savings account if you thought the government might take it away from you and leave you without compensation? Unlikely. The Founders prohibited governmental action of that sort by adopting the Fifth Amendment. In doing so, they created an incentive for Americans to save, invest, and start new enterprises.

### **How important was the Constitution to American prosperity?**

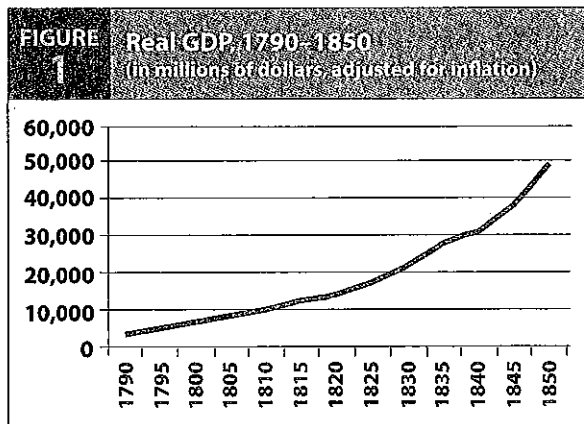
The Constitution established rules that shaped the future development of the U.S. market system. The extraordinary success of the Constitution was in part a result of timing: it came into being at a critical period in American history. It was written by a group of men with immense ability and common interests. They were able to complete their task without significant obstruction from those who did not support the project. In the absence of these conditions, it is doubtful that anybody could have produced a document that would serve us as well.

The Constitution left many questions unanswered, however. Its economic elements, such as the Commerce Clause, still had to be tested in the courts. Several Supreme Court decisions, some issued by the Marshall Court (1801–1835), would be needed to transform the Constitution’s general rules into more specific

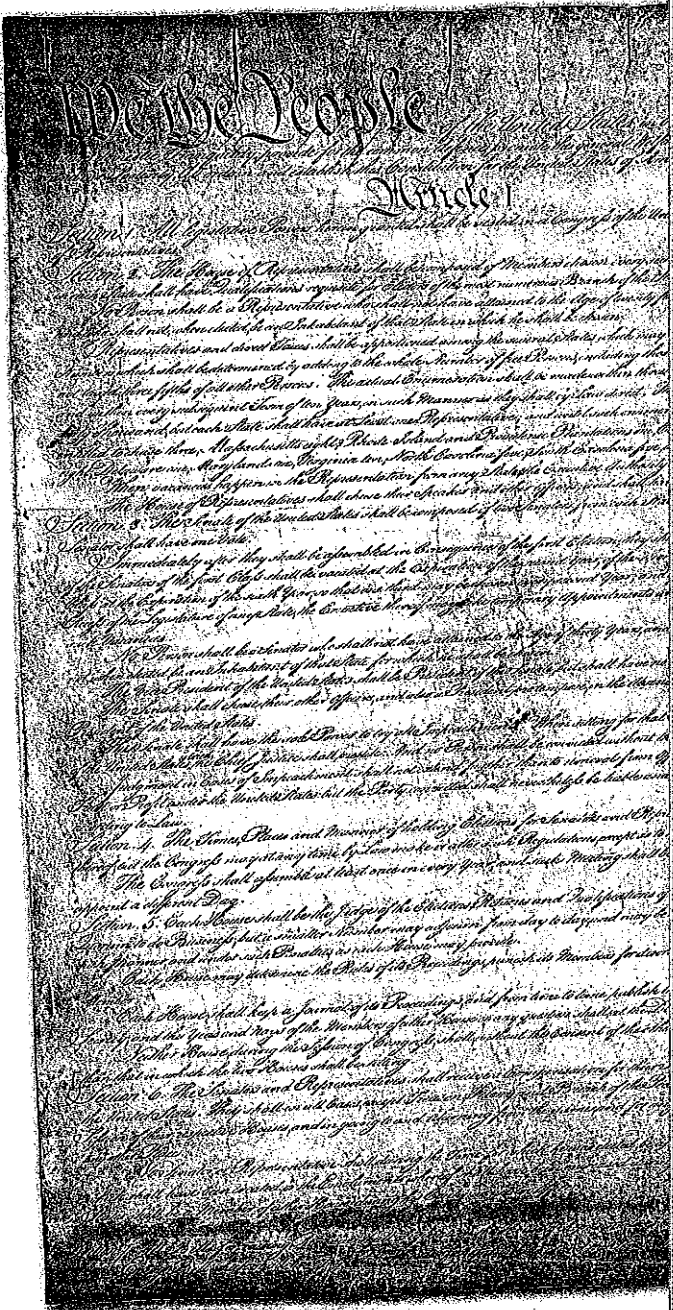


policies. For example, in *Gibbons v. Ogden* (1824), the Court overturned a monopoly granted by the state of New York to steamships operating between New York and New Jersey. This ruling confirmed the point that the federal government, rather than the states, held authority to regulate interstate commerce.

Has the Constitution been an economic success? While cause and effect relationships are difficult to establish, it is significant that the U.S. economy experienced rapid economic expansion from the period of 1790 to 1850. Figure 1 shows the change in Gross Domestic Product (GDP) during the period. GDP represents the dollar value of all the final goods and services produced within a nation during a specific period. Economists regard GDP as an important measure of the overall health of an economy. Although many factors were involved in the rapid growth the United States experienced after 1790, the upward trend must reflect positive effects of the rules of the game established by the Constitution.



Source: Louis Johnston and Samuel H. Williamson, "What Was the U.S. GDP Then?" Measuring Worth, 2010. URL: <http://www.measuringworth.org/usgdp>



### QUESTIONS for DISCUSSION

1. How did the ideas of Adam Smith influence the writing of the U.S. Constitution? Explain your answer.
2. How did the structure of the U.S. Constitution—its allocation of power to three separate branches of government—serve to limit the role the government would play in the new economy? Explain your answer.
3. Which elements of the U.S. Constitution might be regarded as the "Articles of the market economy"?
4. Which economic clause do you regard as the most important for protecting economic freedom? Explain your answer.
5. What evidence is there that the U.S. economy grew after the ratification of the Constitution?

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